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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9612]

RIN 1545-BA53

Noncompensatory Partnership Options

AGENCY: Internal Revenue Service (IRS), Department of the Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The final regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The final regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. The final regulations also contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. The final regulations will affect partnerships that issue noncompensatory options, the partners of such partnerships, and the holders of such options.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Date: These regulations apply to noncompensatory options (as defined in §1.721-2(f)) that are issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

FOR FURTHER INFORMATION CONTACT: Benjamin Weaver at (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under sections 171, 704, 721, 761, 1272, 1273, and 1275 of the Internal Revenue Code (Code). On January 22, 2003, proposed regulations (REG-103580-02) relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership were published in the **Federal Register** (68 FR 2930). On March 28, 2003, corrections to the proposed regulations were published in the **Federal Register** (68 FR 15118). Because no requests to speak were submitted by April 29, 2003, the public hearing scheduled for Tuesday, May 20, 2003, was cancelled (see 68 FR 24903). The Treasury Department and the IRS received a number of comments in response to the proposed regulations. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision. The final regulations apply to certain call options, warrants, convertible debt, and convertible equity that are not issued in connection with the performance of services (noncompensatory options). All comments are available at www.regulations.gov or upon request.

Summary of Comments and Explanation of Provisions

The final regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory partnership options. The final regulations apply only if the call option, warrant, or conversion right grants the holder the right to acquire an interest in the issuer (or cash measured by the value of the interest). The final regulations generally provide that the exercise of a noncompensatory option does not cause recognition of gain or loss to either the issuing partnership or the option holder. In addition, the final regulations modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Finally, the final regulations contain a characterization rule providing that the holder of a call option, warrant, convertible debt, or convertible equity issued by a partnership (or an eligible entity, as defined in §301.7701-3(a), that would become a partnership if the option holder were treated as a partner) is treated as a partner under certain circumstances.

A number of comments were received regarding the proposed regulations. The comments included requests for clarification and recommendations relating to (1) the issuance and exercise of noncompensatory options; (2) accounting for noncompensatory options; (3) the characterization rule; (4) the convertible bond provision; and (5) the application of the original issue discount provisions. Significant comments are further discussed in this preamble.

1. Issuance, Exercise, Lapse, Repurchase, and other Terminations of a Noncompensatory Option

Like the proposed regulations, the final regulations under section 721 define a noncompensatory option as an option issued by a partnership, other than an option issued in connection with the performance of services. For this purpose, an option is defined as a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt, or the conversion feature of convertible equity.

A. Application of section 721 on issuance of a noncompensatory option

The proposed regulations provide that section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. Several commenters observed that the proposed regulations do not exclude options issued in satisfaction of interest or similar items, such as unpaid rent or royalties. Accordingly, the final regulations provide that section 721 does not apply to the transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a partnership obligation with a noncompensatory option. The final regulations contain an example illustrating that a transfer of appreciated or depreciated property to a partnership in exchange for a noncompensatory option generally will result in the recognition of gain or loss by the option recipient. Under open transaction principles applicable to noncompensatory options, the partnership will not recognize income for receipt of the property while the option is outstanding. Notwithstanding the general rule, the Treasury Department and IRS believe it is appropriate to take into account the

conversion right embedded in convertible equity as part of the underlying partnership interest. Accordingly, the final regulations provide that section 721 does apply to a contribution of property to a partnership in exchange for convertible equity in a partnership.

B. Application of section 721 on exercise of a noncompensatory option

i. Payment of the Exercise Price with Property or Cash

The proposed regulations provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership. The final regulations generally adopt this rule. However, in response to comments requesting clarification, the final regulations also provide that section 721 generally applies to the exercise of a noncompensatory option when the exercise price is satisfied with property or cash contributed to the partnership, regardless of whether the terms of the option require or permit a cash payment.

ii. Exercise of a Noncompensatory Option in Satisfaction of a Partnership Obligation

The proposed regulations under section 721 do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). A number of comments were received requesting clarification on the proper treatment of accrued but unpaid interest. Since the proposed regulations were issued and the comments received, final regulations under section 721 were published on November 17, 2011 (TD 9557) addressing certain partnership debt-for-equity exchanges. Section 1.721-1(d)(2) provides:

Section 721 does not apply to a debt-for-equity exchange to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. The debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including accrued original issue discount).

The preamble to TD 9557 explains this provision as follows: "The IRS and the Treasury Department believe that the exception to section 721 for these items is necessary to prevent the conversion of ordinary income into capital gain."

The Treasury Department and the IRS believe that similar considerations arise in the context of the exercise of noncompensatory options. Accordingly, the final regulations provide that section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. Additionally, the final regulations provide that section 721 does not apply to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation.

The proposed regulations do not specify whether, upon conversion of convertible debt in the partnership, the partnership is treated as satisfying its obligation for unpaid

interest with a fractional interest in each partnership property. Under this “vertical slice” approach, the partnership could recognize gain or loss equal to the difference between the fair market value of each partial property deemed transferred to the creditor and the partnership’s adjusted basis in that partial property. The Treasury Department and the IRS believe that approach would be difficult to administer and may inappropriately accelerate gain or loss recognition. Therefore, the final regulations provide that the partnership will not recognize gain or loss upon the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the partnership to the extent that the transfer is in satisfaction of the partnership’s indebtedness for unpaid interest (including accrued original issue discount) on convertible debt that accrued on or after the beginning of the convertible debt holder’s holding period for the indebtedness. Additionally, the final regulations also provide that the issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of the partnership’s obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder’s holding period for the obligation. This treatment is consistent with the rules under §1.721-1(d)(2).

iii. Options Issued by Disregarded Entities

The rule in the proposed regulations providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity, as defined in §301.7701-3(a), that would

become a partnership under §301.7701-3(f)(2) if the option, warrant, or conversion right were exercised. The Treasury Department and the IRS requested and received comments on whether the nonrecognition rule should be extended to such instruments. Commenters recommended that the nonrecognition rule should be extended to such instruments. However, some commenters noted that the extension of the proposed regulations to include a noncompensatory option issued by an eligible entity that would become a partnership under §301.7701-3(f)(2) upon exercise of the option would necessitate adjustments to the capital accounting requirements of the regulations, as applied to these entities. Without these adjustments, upon exercise of the option, the owner of the eligible entity would be treated as contributing all property owned by the eligible entity prior to exercise of the option to the new partnership, while the option holder would be treated as contributing only the exercise price and premium to the new partnership. The new partnership would have no unbooked unrealized gain in its property that it could allocate to the exercising option holder. Accordingly, the Treasury Department and the IRS have decided not to apply the rules of the final regulations to these instruments.

iv. Application of Section 721(b)

One commenter requested clarification of whether section 721(b) could apply to the exercise of a noncompensatory option under the regulations. Section 721(b) provides that section 721(a) does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of

section 351) if the partnership were incorporated. The Treasury Department and the IRS believe that section 721, including the provisions of section 721(b) and §1.721-1(a), applies to the exercise of noncompensatory options.

v. Cash Settled Options

Several commenters requested guidance on the treatment of cash-settled options, particularly regarding whether the cash settlement of an option is treated as a sale or exchange of the option or as an exercise of the option followed by an immediate redemption of the newly-issued partnership interest. The Treasury Department and the IRS believe that the cash settlement of a noncompensatory option should be treated as a sale or exchange of the option and taxed under the rules of section 1234, rather than as a contribution to the partnership under section 721, followed by an immediate redemption (although the latter may, in certain instances, be treated as a sale of the option under the disguised sale rules). The final regulations provide that the settlement of a noncompensatory option in cash or property other than an interest in the issuing partnership is not a transaction to which section 721 applies.

C. Lapse, repurchase, sale, or exchange of a noncompensatory option

The proposed regulations provide that section 721 does not apply to the lapse of a noncompensatory option. Accordingly, the lapse of a noncompensatory option generally results in the recognition of income by the partnership and loss by the holder of the lapsed option in an amount equal to the option premium. However, the proposed regulations do not address the character of the gain or loss recognized upon lapse,

repurchase, sale, or exchange of the option.

While section 1234(b) provides that gain or loss from any closing transaction generally is treated as short term capital gain or loss to the grantor of an option, commenters were uncertain whether section 1234(b) applies to partnership interests because it is unclear whether partnership interests qualified as “securities” for purposes of section 1234(b). To eliminate this uncertainty, proposed regulations under section 1234(b) (REG-106918-08) are being published concurrently with these final regulations, which treat partnership interests as securities for this purpose. The preamble to those proposed regulations also addresses, and seeks comments on, the character of gain or loss to the option holder on the sale or exchange of, or loss on failure to exercise, an option.

D. Application of general tax principles in certain situations

In the event that the exercise of a noncompensatory option is followed by a redemption of the exercising option holder’s partnership interest, general tax principles, including the disguised sale rules of section 707(a)(2)(B), will apply in determining whether the transaction is actually a cash settlement of the noncompensatory option by the partnership.

The proposed regulations provide that if the exercise price of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature. Similarly, the final regulations provide that, if the exercise price of a

noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to determine the tax consequences of the transaction. The final regulations are based on the premise that the partnership and the option holder will act in an economically rational way, such that an option holder generally will not exercise the option unless the capital account received will equal or exceed the exercise price. It should be noted that a noncompensatory option could be economically viable to exercise when the option holder receives a right to share in partnership capital that is less than the sum of the premium paid for the option and the exercise price of the option, provided that the exercise price alone does not exceed the capital account received. This simply reflects the fact that the premium is a sunk cost at the time the option holder exercises the option.

2. Accounting for Noncompensatory Options

A. Accounting for the issuance of a noncompensatory option

Under the proposed regulations, issuance of a noncompensatory option is not a permissive or mandatory revaluation event under Treas. Reg. §1.704-1(b)(2)(iv). One commenter noted that, as a result, unrealized gain in partnership property arising prior to the issuance of the option could be inappropriately shifted to the option holder upon exercise. The Treasury Department and the IRS agree. Therefore, the final regulations provide that the issuance by a partnership of a noncompensatory option (other than an option for a de minimis partnership interest) is a permissible revaluation event.

B. Revaluations while a noncompensatory option is outstanding

Under the proposed regulations, any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value of any outstanding noncompensatory options. If the fair market value of outstanding noncompensatory options as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the value of partnership property reflected on the partnership's books must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. Conversely, if the price paid by the option holders to acquire the outstanding noncompensatory options exceeds the fair market value of the options as of the date of the adjustment, then the value of partnership property reflected on the partnership's books must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.

The Treasury Department and the IRS have decided to retain these rules with certain modifications. The final regulations continue to provide that the adjustments to the value of partnership property reflected on the partnership's books should generally be made to partnership properties on a pro rata basis. Several comments were

received requesting additional guidance when certain properties are subject to special allocations to existing partners. The Treasury Department and the IRS agree that the final regulations should take into account the economic arrangement of the parties. Therefore, the final regulations provide that the adjustments must take into account the economic arrangement of the partners with respect to the property.

One commenter noted that, while the proposed regulations do not state how the fair market value of the outstanding option should be computed, the value that is consistently used in the examples in the proposed regulations is the liquidation value of the option assuming exercise. The commenter requested additional guidance on the determination of the fair market value of outstanding options. The Treasury Department and the IRS believe that additional guidance on the determination of fair market value is unnecessary and believe that the examples sufficiently illustrate that the fair market value of an outstanding option may be based on the liquidation value of the option assuming exercise.

C. Accounting for the exercise of a noncompensatory option

The proposed regulations provide that an exercising noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the noncompensatory option and the fair market value of any property (other than the option) contributed to the partnership upon the exercise of the noncompensatory option. The proposed regulations provide that upon the conversion of convertible equity, the fair market value of property contributed to the partnership

includes the converting partner's capital account immediately before the conversion. Because the converting partner's pre-conversion capital account will not be eliminated because of the conversion, the Treasury Department and the IRS believe that this provision from the proposed regulations is unnecessary and could cause confusion. Therefore, the Treasury Department and the IRS have decided to remove this provision to eliminate confusion; no substantive change is intended by this revision.

Additionally, the proposed regulations provide that the capital account of a holder of convertible debt is credited with the adjusted basis of the debt and the accrued but unpaid qualified stated interest on the debt immediately before the conversion of the debt. One commenter noted that the regulations should credit the debt holder's capital account with the adjusted issue price rather than the adjusted basis of the debt. Using adjusted issue price avoids creating a different tax result in cases in which the debt is converted by the original debt holder versus cases in which the debt is converted after a transfer of the debt at a price that reflected unrealized gain or loss attributable to the conversion right and/or changes in market interest rates. The Treasury Department and the IRS agree with this comment and, therefore, the final regulations credit the capital account of a convertible debt holder with the adjusted issue price of the debt and the accrued but unpaid qualified stated interest on the debt immediately before the conversion of the debt.

The proposed regulations require a partnership to revalue its property immediately following the exercise of a noncompensatory option, after the option holder

has become a partner. The partnership must allocate the unrealized income, gain, loss, and deduction from this revaluation, first, to the noncompensatory option holder on exercise to the extent necessary to reflect the option holder's right to share in partnership capital under the partnership agreement and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of the property for its fair market value on that date. To the extent that unrealized appreciation or depreciation in the partnership's property has been allocated to the capital account of the noncompensatory option holder on exercise, the holder will, under section 704(c) principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying properties are sold, depreciated, or amortized. The final regulations adopt these provisions with some modifications.

Under the current section 704(b) regulations, a revaluation of partnership property pursuant to §1.704-1(b)(2)(iv)(f) is based on the fair market value of partnership property as of the date of the revaluation, as determined under §1.704-1(b)(2)(iv)(h). Several commenters to the proposed regulations recommended that the section 704(b) regulations be revised to permit revaluations of partnership property based on the fair market value of the partnership interest, rather than the fair market value of the partnership's property. These values may differ because of restrictions on the transferability or liquidity of the partnership interest or other factors. The Treasury Department and the IRS have decided to continue requiring that revaluations be based

on the fair market value of the partnership's property. The Treasury Department and the IRS believe that changing the rules for all revaluations is beyond the scope of these final regulations.

Several comments were received requesting additional guidance on adjusting capital accounts upon exercise of an option when certain partnership properties are subject to special allocations to existing partners. The final regulations clarify that the allocations must take into account the economic arrangement of the partners with respect to the property.

Furthermore, several commenters requested additional guidance on how to adjust capital accounts upon exercise when the partnership owns multiple properties with unrealized income, gain, loss, or deduction. The final regulations clarify that allocations should be made on a pro rata basis from partnership property, subject to the requirement that the allocations take into account the economic arrangement of the partners. Thus, if the exercising partner's right to share in partnership capital under the partnership agreement exceeds the sum of the premium and exercise price, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation (subject to the requirement that the allocations take into account the economic arrangement of the partners). Conversely, if the exercising partner's right to share in partnership capital under the partnership agreement is less than the premium and exercise price, then only loss may be allocated to the exercising partner from

partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss (subject to the requirement that the allocations take into account the economic arrangement of the partners).

One commenter recommended that the final regulations provide that the partnership may revalue its assets immediately before the exercise of the option (in addition to the revaluation that occurs immediately following the exercise of the option). This comment was made in response to one issue that arises when a revaluation event under §1.704-1(b)(2)(iv)(f) or (s) occurs while a noncompensatory option is outstanding and certain partnership property has increased in value. If, following the revaluation, but prior to the exercise of the option, the same property declines in value before the option is exercised, there may be insufficient unrealized income or gain in partnership property (that has not been allocated to the capital accounts of other partners) to allocate to the option holder's capital account upon exercise. To address this issue, one commenter recommended that, for purposes of partnership property revaluations, the portion of the unrealized gain that is treated as "reflected in the capital accounts previously" be reduced by the historic partners' share of the decline in asset value. The Treasury Department and the IRS have decided not to adopt these changes because the increased complexity that these new rules would add to the regulations outweighs the potential benefit.

Under the proposed regulations, if, after the allocations of unrealized gain and loss items to an exercising option holder, the exercising option holder's capital account

still does not reflect his right to share in partnership capital under the partnership agreement, the partnership must reallocate capital between the existing partners and the exercising option holder (a “capital account reallocation”). This capital account reallocation provision has been retained from the proposed regulations.

D. Corrective allocations

The proposed regulations require the partnership to make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners’ capital accounts that occurs as a result of a capital account reallocation pursuant to the exercise of a noncompensatory option. Corrective allocations are allocations of tax items that differ from the partnership’s allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership’s tax allocations to the capital account reallocation, additional corrective allocations are required in succeeding taxable years until the capital account reallocation has been fully taken into account.

A number of comments were received regarding the requirement of corrective allocations in the proposed regulations. Some commenters recommended eliminating or substantially limiting the scope of corrective allocations. The Treasury Department and the IRS considered other alternatives but believe that corrective allocations are the most administrable alternative means to address the potential problem of income shifting when, prior to the exercise of a noncompensatory option, a partnership recognizes gain or loss that is, in part, economically attributable to the option holder, but

is allocated entirely to the existing partners. Therefore, the final regulations retain the requirement for corrective allocations in certain circumstances.

i. Corrective Allocations when Historic Partners Depart

The final regulations require corrective allocations to be made so as to take into account any capital account reallocation upon exercise of a noncompensatory option. Therefore, partnership items may be correctively allocated to the exercising option holder only of items properly allocable to a partner that suffered a capital account reduction and only to the extent such partner suffered a capital account reduction. This approach may result in corrective allocations not being fully made if a partner that suffered a capital account reduction on exercise is no longer a partner in the issuing partnership at the time a corrective allocation would otherwise be made.

ii. Character Matching for Corrective Allocations

The proposed regulations provide that corrective allocations are pro rata allocations of gross income and gain or gross loss and deduction. The proposed regulations do not require any matching of character between the income or loss that is correctively allocated, and gains or losses that were allocated to existing partners prior to the option's exercise, but that were economically attributable to the option holder. Several commenters recommended that the regulations provide some type of matching requirement. The Treasury Department and the IRS believe that the complexity that could arise from a character matching requirement would outweigh the potential benefit of obtaining a more precise tax result for corrective allocations in some cases.

Accordingly, the final regulations do not provide for a character matching requirement.

iii. Corrective Allocations Using Combinations of Income and Loss

Additionally, some commenters requested guidance on making corrective allocations in a year in which the partnership has both gross income and gain and gross loss and deduction. In some cases, a corrective allocation that completely takes into account the capital shift may not be possible in a given year if only gross income and gain, or gross loss and deduction, are used. However, commenters noted that it may be possible to more fully take into account the capital shift if corrective allocations are made using a combination of gross income and gain and gross loss and deduction. The Treasury Department and IRS agree that combinations of gross income and gain and gross loss and deduction should be available for corrective allocations.

Accordingly, the final regulations provide a mechanism for making corrective allocations using combinations of gross income and gain and gross loss and deduction in certain circumstances. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and

deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross income and gain as to further take into account the capital account reallocation.

iv. Application of Section 706 to Corrective Allocations

One commenter requested clarification on the application of section 706 to the corrective allocation provisions. Because the exercise of a noncompensatory option may cause the partners' interests in the partnership to vary, the Treasury Department and the IRS believe that section 706 should apply in determining which items may be used for corrective allocations. Therefore, the final regulations also clarify that section 706 and its regulations and principles apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation.

E. The impact of partnership mergers, divisions, and terminations on outstanding noncompensatory options

The proposed regulations do not address the impact of partnership mergers, divisions, and section 708 technical terminations on outstanding noncompensatory options. Some commenters requested guidance on these situations. The Treasury Department and the IRS believe that these issues are beyond the scope of these final regulations.

3. Characterization Rule

The proposed regulations generally respect noncompensatory options as such and do not characterize them as partnership equity. However, the proposed regulations

characterize the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule under the proposed regulations applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate Federal tax liabilities. The proposed regulations use a facts and circumstances test to determine whether a noncompensatory option holder's rights are substantially similar to the rights afforded to a partner. The facts and circumstances for making this determination under the proposed regulations include, but are not limited to, whether the option is reasonably certain to be exercised and whether the option holder has partner attributes. The Treasury Department and the IRS have decided to retain these rules with certain modifications.

A. The “substantially similar” test

Some commenters criticized the breadth of the language in the proposed regulations that provides that all facts and circumstances will be considered in determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, suggesting instead that an exclusive list of factors be used. The Treasury Department and the IRS agree that the regulations should more specifically describe the circumstances in which an option holder will be considered to possess these rights. Therefore, the final regulations

provide that a noncompensatory option provides its holder with rights that are substantially similar to the rights afforded to a partner if the option is reasonably certain to be exercised or if the option holder possesses partner attributes.

i. The “reasonably certain to be exercised” test

The proposed regulations list a number of non-exclusive factors that are used to determine whether a noncompensatory option is reasonably certain to be exercised, including the fair market value of the partnership interest that is the subject of the option, the exercise price of the option, the term of the option, the predictability and stability of the value of the underlying partnership interest, the fact that the option premium and exercise price (if the option is exercised) will become property of the partnership, and whether the partnership is expected to make distributions during the term of the option. With one exception, the final regulations adopt these factors and clarify that any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised will be considered a factor in determining whether an option is reasonably certain to be exercised. Because the option premium represents a sunk cost to the option holder, and because the fact that the exercise price becomes property of the partnership is already reflected in the value of the partnership interest subject to the option, the final regulations do not include as a factor in the reasonable certainty test the fact that the option premium and exercise price will become property of the partnership.

Some commenters suggested that the characterization rule in the regulations

adopt standards similar to those found in §1.1361-1(l) for determining whether there is a second class of stock in an S corporation, or those found in §1.1504-4 for determining whether a corporation is a member of an affiliated group. Commenters also recommended that the regulations provide for certain safe harbors and bright line tests for determining whether an option holder's rights are substantially similar to the rights afforded to a partner, and whether there is a strong likelihood that the failure to treat the holder as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities. After careful consideration of these comments, the Treasury Department and the IRS believe that limited safe harbors should be provided to limit the administrative burdens of the characterization rule. Accordingly, the final regulations provide two objective safe harbors, which are similar to two of the safe harbors in §1.1504-4 and §1.1361-1(l). However, these safe harbors apply only to the determination of whether a noncompensatory option is reasonably certain to be exercised, and not to the determination of whether a noncompensatory option holder possesses partner attributes.

The first safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if it may be exercised no more than 24 months after the date of the applicable measurement event and it has a strike price equal to or greater than 110 percent of the fair market value of the underlying partnership interest on the date of the measurement event. The second safe harbor provides that a noncompensatory option is not considered reasonably certain to be exercised if the

terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date. For purposes of these safe harbors, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

The safe harbors do not apply, however, if the parties to the noncompensatory option had a principal purpose of substantially reducing the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

The final regulations provide that failure of an option to satisfy one of these safe harbors does not affect the determination of whether the option is treated as reasonably certain to be exercised. Thus, options that do not satisfy the safe harbors may still be treated as not reasonably certain to be exercised under the facts and circumstances. Notwithstanding that an option is treated as not reasonably certain to be exercised on the date of one measurement event under either the safe harbors or the facts and circumstances test, the option may be treated as reasonably certain to be exercised at the time of a subsequent measurement event if the safe harbors and facts and circumstances test are no longer satisfied. Furthermore, even if an option is not reasonably certain to be exercised under either the safe harbors or the facts and

circumstances test, the noncompensatory option may still be found to provide its holder with rights substantially similar to those afforded a partner under the partner attributes test.

The proposed regulations contain an example describing an option issued by a partnership with reasonably predictable earnings and concluding, based on the facts of the example, that the option described is reasonably certain to be exercised.

Commenters stated that the example involved unrealistic facts demonstrating reasonably predictable earnings, and that the example wrongly implied that low volatility suggests a reasonable certainty of exercise. Upon further consideration of this example, the Treasury Department and the IRS have decided to delete the example from the final regulations.

ii. The “partner attributes” test

The proposed regulations provide that partner attributes include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss and the extent to which the option holder has the right to control or restrict the activities of the partnership. Some commenters requested clarification of this definition of partner attributes. Because all options issued by a partnership allow the holder to share, to some extent, in the economic benefit and detriment of partnership income and loss, the Treasury Department and the IRS agree that this language should be clarified.

The final regulations provide that the determination of whether a

noncompensatory option holder possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting or managerial rights in the partnership. Additionally, the final regulations provide that an option holder has partner attributes if, based on all the facts and circumstances, (1) the option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interest; or (2) the option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses. In this way, the Treasury Department and the IRS believe that the final regulations clarify that the economic benefits and burdens relevant to the partner attributes test are those beyond the economic benefits and burdens inherent in basic option transactions.

As to an option holder's ability to control or restrict the activities of the partnership, some commenters stated that an option holder should not be considered to possess partner attributes solely because the holder has the ability to restrict partnership distributions or dilutive issuances of partnership equity while the option is outstanding. Option holders often are given such rights as a means of protecting the value of the option holder's potential future partnership interest. The Treasury

Department and the IRS agree that such rights are reasonable restrictions that, by themselves, should not automatically lead to a conclusion that the option holder possesses partner attributes. Accordingly, the final regulations provide that a noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the right to significantly control or restrict, a partnership decision that could substantially affect the value of the underlying partnership interest. In particular, the following rights of the option holder will not be treated as partner attributes: (1) the ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding; and (2) the ability to choose the partnership's section 704(c) method for partnership properties.

Some commenters requested clarification on the analysis of partner attributes for an option holder who is also a partner in the issuing partnership. The proposed regulations provide that rights possessed by an option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option are not taken into account in determining whether the option holder has partner attributes, provided those rights are no greater than those held by other partners owning substantially similar interests. Commenters noted that, in some cases, there may be partners, such as managing or general partners, with unique interests that are not comparable to the interests of any other partners. The Treasury Department and the

IRS agree that the regulations should address these situations. Accordingly, the final regulations provide that rights in the issuing partnership possessed by a noncompensatory option holder solely by virtue of owning an interest in the issuing partnership are not taken into account, provided that those rights are no greater than the rights granted to other partners owning substantially similar interests in the partnership and who do not hold noncompensatory options in the partnership.

Additionally, the final regulations provide that if all of the partners owning substantially similar interests in the issuing partnership also hold noncompensatory options in the partnership, or if none of the other partners owns substantially similar interests in the partnership, then all facts and circumstances will be considered in determining whether the rights in the partnership possessed by the option holder are possessed solely by virtue of owning a partnership interest. If those rights are possessed solely by virtue of owning a partnership interest, the final regulations provide that they are not taken into account.

Additionally, in response to comments, the final regulations provide that for purposes of determining whether an option holder has partner attributes, the option holder will be treated as owning all partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the option holder. For example, if the holder of a noncompensatory option is related to a person that owns an interest in the issuing partnership, and the interest provides the related person with partner attributes that are greater than the rights granted to other partners owning

substantially similar interests in the partnership, the option will be characterized as a partnership interest under the final regulations if the strong likelihood test is satisfied. This provision is intended to prevent avoidance of the partner attributes test by planning among related parties. The Treasury Department and the IRS continue to study the extent to which financial instruments and partnership interests owned by related persons should be taken into account under the reasonable certainty test.

The proposed regulations contain an example describing a deep in the money option and concluding, based on the facts of the example, that the option holder possesses partner attributes. Commenters stated that the example added little to the existing guidance provided by the common law rule. Upon further consideration of this example, the Treasury Department and the IRS have decided to delete the example from the final regulations.

B. The “strong likelihood” test

The Treasury Department and the IRS received a number of comments regarding the provision in the proposed regulations that the characterization rule applies only if there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners’ and the holder’s aggregate tax liabilities. Some commenters recommended that the regulations adopt language similar to that contained in §1.704-1(b)(2)(iii)(b)(2) and (c)(2), which provides that, in determining whether there is a reduction in the partners’ total tax liability, tax consequences that result from the interaction of the allocation(s) with

partner tax attributes that are unrelated to the partnership are taken into account. Similarly, in determining whether there would be a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities, commenters noted that it is appropriate to consider partner and option holder tax attributes that are unrelated to the partnership, and the interaction of those attributes with the option.

The Treasury Department and the IRS agree that it would be helpful for the regulations to specify certain factors that are considered in determining whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate Federal tax liabilities. The final regulations provide that all facts and circumstances should be considered in making this determination, including: (1) the interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Federal tax attributes that are unrelated to the partnership); (2) the absolute amount of the Federal tax reduction; (3) the amount of the reduction relative to overall Federal tax liability; and (4) the timing of items of income and deductions.

Additionally, to more specifically address the application of the strong likelihood test when a look-through entity (as defined in §1.704-1(b)(2)(iii)(d)(2)) is a party, the final regulations provide that if a partner or option holder is a look-through entity, such

as a partnership or an S corporation, then the tax attributes of that entity's ultimate owners (that are not look-through entities) will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction. The final regulations also provide that, if a partner is a member of a consolidated group, then tax attributes of the consolidated group and of another member with respect to a separate return year will be taken into account in determining whether there is a strong likelihood of a substantial tax reduction.

C. Events that trigger testing under the characterization rule

The proposed regulations test a noncompensatory option under the characterization rule upon issuance, transfer, or modification of the option. A number of comments were received recommending clarification, or narrowing of the list, of events that will trigger a testing of the option after original issuance. Several commenters argued that only material modifications of an option should lead to re-testing under the characterization rule. Several commenters also recommended restricting the types of transfers that will trigger testing of the option under the characterization rule, or removing the requirement to test upon transfer entirely. In response to these comments, the final regulations provide a more detailed description of the events that will trigger application of the characterization rule to a noncompensatory option.

The final regulations provide that the characterization rule will be applied upon the occurrence of a measurement event with respect to the noncompensatory option. The final regulations define a measurement event as: (1) issuance of the

noncompensatory option; (2) an adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest); or (3) transfer of the noncompensatory option if either (A) the term of the option exceeds 12 months, or (B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder.

Additionally, in response to the comments, the Treasury Department and the IRS believe that it is appropriate to limit testing under the characterization rule to provide certainty for both taxpayers and the IRS, particularly in circumstances in which there is little potential for abuse. Therefore, the final regulations do not treat the following events as measurement events: (1) a transfer of the noncompensatory option that would otherwise be a measurement event if the transfer is at death or between spouses or former spouses under section 1041, or in a transaction that is disregarded for Federal tax purposes; (2) a modification that neither materially increases the likelihood that the option will be exercised nor provides the option holder with partner attributes; (3) a change in the strike price of a noncompensatory option, or in the interests in the issuing partnership that may be issued or transferred pursuant to the option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the option holder; and (4) any other event as provided in

guidance published in the Internal Revenue Bulletin. The Treasury Department and the IRS believe that these limitations will minimize the burden on taxpayers that could arise from frequent testings under the characterization rule in many situations, while preserving the ability of the IRS to enforce the characterization rule in appropriate circumstances.

Some commenters also requested that the regulations clarify whether the issuance, transfer, or modification of one noncompensatory option would trigger testing under the characterization rule of all other outstanding noncompensatory options issued by the same partnership. Under the final regulations, testing under the characterization rule occurs only on the date a measurement event occurs with respect to a particular noncompensatory option. Measurement events should be determined individually for each noncompensatory option issued by a partnership. For example, the modification of one noncompensatory option generally would be a measurement event for that particular option, and it would not be a measurement event for all other noncompensatory options issued by the partnership.

In addition, to address transfers of interests in the issuing partnership and situations involving look-through entities, proposed regulations under section 761 (REG-106918-08) are being published concurrently with these final regulations. Those proposed regulations would add three measurement events to the list above, but apply only if those measurement events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose

the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder. The proposed measurement events are: (1) issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership; (2) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory option; and (3) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership. The Treasury Department and the IRS believe that the first of these proposed measurement events is necessary because it is inconsistent to test a noncompensatory option under the characterization rule upon transfer of the noncompensatory option, but not upon transfer of an interest in the issuing partnership, because either type of transfer may change the analysis of whether there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities. The Treasury Department and the IRS believe that the second and third proposed measurement events are necessary to prevent avoidance of the characterization rule through the use of look-through entities.

D. Timing of characterization

Some commenters requested clarification regarding the timing of the characterization of a noncompensatory option as a partnership interest under the regulations. For example, some commenters questioned whether an option that was

characterized as a partnership interest upon transfer would be treated as transferred and then exercised by the transferee or exercised by the transferor and then transferred. The Treasury Department and the IRS believe that the tax consequences to the transferor and transferee upon a transfer of the option should be similar to the tax consequences upon a transfer of the underlying partnership interest. Accordingly, the final regulations provide that characterization of an option as a partnership interest under the regulations applies upon the issuance of the option, or immediately before any other measurement event that gave rise to the characterization. Under this approach, if the characterization rule applied upon a transfer of a noncompensatory option, a section 743 adjustment for the benefit of the transferee would be made if the issuing partnership had a section 754 election in effect.

E. Effect of characterization

Some commenters questioned whether, once a noncompensatory option was characterized as a partnership interest under the characterization rule, the characterization rule could ever operate to re-characterize the interest as a noncompensatory option once again. The Treasury Department and the IRS believe that the characterization rule operates to treat noncompensatory options as partnerships interests in appropriate circumstances, and it should not be interpreted to treat partners as noncompensatory option holders. Accordingly, the final regulations provide that once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.

F. Continuing applicability of general tax principles

Finally, some commenters questioned whether general tax principles would continue to apply to the characterization of a noncompensatory option that, in substance, represents a current partnership interest. Because these rules in the final regulations are intended to supplement rather than supplant general tax principles, the Treasury Department and the IRS believe it is appropriate for general tax principles to continue to apply, in addition to the characterization rule of the regulations. Thus, the final regulations clarify that an option that is not treated as a partnership interest under the regulations may still be treated as a partnership interest under general principles of law. For example, if upon the issuance of a noncompensatory option, the option in substance constitutes a partnership interest under general tax principles, then the option will be treated as a partnership interest for Federal tax purposes, even if it is unlikely that the aggregate tax liabilities of the option holder and partners would be substantially reduced by the failure to treat the option holder as a partner. For this purpose, general tax principles include principles of tax law derived from the Internal Revenue Code, Treasury Regulations, case law, and administrative guidance issued by the IRS.

4. Convertible Bond Provision

Section 171(b)(1) provides that the amount of bond premium on a convertible bond does not include any amount attributable to the conversion features of the bond. A holder of partnership convertible debt who purchases the debt at a premium would

generally be subject to the section 171 bond premium amortization rules. One commenter suggested that the regulations under §1.171-1(e)(1)(iii) be clarified to state that such regulations apply to debt that is convertible into an interest in the partnership issuing the debt. The final regulations adopt this comment.

5. Original Issue Discount Provisions

The original issue discount (OID) provisions provide special rules for debt instruments convertible into the stock of the issuer or a party related to the issuer. See §§1.1272-1(e), 1.1273-2(j), and 1.1275-4(a)(4). The proposed regulations proposed to apply these special rules to debt instruments convertible into partnership interests. These final regulations adopt these proposed amendments. Accordingly, the final regulations amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments. Treating convertible debt issued by partnerships and corporations differently for purposes of these special rules could create unjustified distinctions between the taxation of instruments that are economically equivalent.

Effective/Applicability Date

These final regulations apply to noncompensatory options that are issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses, and no comments were received.

Drafting Information

The principal author of these regulations is Benjamin Weaver of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of the Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.171-1 is amended by adding a sentence at the end of paragraph (e)(1)(iii)(C) to read as follows:

§1.171-1 Bond premium.

* * * * *

(e) * * *

(1) * * *

(iii) * * *

(C) * * * For bonds issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 3. Section 1.704-1 is amended as follows:

1. Paragraph (b)(0) is amended by adding entries to the table in numerical order for paragraphs (b)(2)(iv)(d)(4), (b)(2)(iv)(h)(1), (b)(2)(iv)(h)(2), (b)(2)(iv)(s), (b)(4)(ix), and (b)(4)(x).

2. The paragraph heading for paragraph (b)(1)(ii) is revised and a sentence is added at the end of the paragraph.

3. Paragraph (b)(2)(iv)(d)(4) is added.

4. Paragraph (b)(2)(iv)(f)(1) is revised.

5. Paragraph (b)(2)(iv)(f)(5)(iii) is amended by removing the “.” at the end of the paragraph and adding in its place “, or”.

6. Paragraph (b)(2)(iv)(f)(5)(iv) is redesignated as paragraph (b)(2)(iv)(f)(5)(v).

7. New paragraph (b)(2)(iv)(f)(5)(iv) is added.

8. Paragraph (b)(2)(iv)(h) is redesignated as (b)(2)(iv)(h)(1) and a new paragraph heading is added for paragraph (b)(2)(iv)(h)(1).

9. Paragraph (b)(2)(iv)(h)(2) is added.

10. The undesignated text following paragraph (b)(2)(iv)(r)(2) is designated as paragraph (b)(2)(iv)(r)(3), and a paragraph (b)(2)(iv)(s) is added after the newly designated paragraph (b)(2)(iv)(r)(3).

11. Paragraphs (b)(4)(ix) and (b)(4)(x) are added.

12. Paragraph (b)(5) is amended by adding Examples 31 through 35.

The additions and revisions read as follows:

§1.704-1 Partner’s distributive share.

* * * * *

(b) * * * (0) * * *

Heading	Section
* * * * *	
Exercise of noncompensatory options.....	1.704-1(b)(2)(iv)(d)(4)
* * * * *	
In general.....	1.704-1(b)(2)(iv)(h)(1)
Adjustments for noncompensatory options.....	1.704-1(b)(2)(iv)(h)(2)
* * * * *	
Adjustments on the exercise of a noncompensatory option.....	1.704-1(b)(2)(iv)(s)
* * * * *	

Allocations with respect to noncompensatory options...	1.704-1(b)(4)(ix)
Corrective allocations.....	1.704-1(b)(4)(x)
* * * * *	

(1) * * *

(ii) Effective/applicability date. * * * In addition, paragraph (b)(2)(iv)(d)(4), paragraph (b)(2)(iv)(f)(1), paragraph (b)(2)(iv)(f)(5)(iv), paragraph (b)(2)(iv)(h)(2), paragraph (b)(2)(iv)(s), paragraph (b)(4)(ix), paragraph (b)(4)(x), and Examples 31 through 35 in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721-2(f)) that are issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

* * * * *

(2) * * *

(iv) * * *

(d) * * *

(4) Exercise of noncompensatory options. Solely for purposes of paragraph (b)(2)(iv)(b)(2) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in §1.721-2(f)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option is the adjusted issue price of the debt and the accrued but unpaid qualified stated

interest (as defined in §1.1273-1(c)) on the debt immediately before the conversion, plus the fair market value of any property (other than the convertible debt) contributed to the partnership on the exercise of the option. See Examples 31 through 35 of paragraph (b)(5) of this section.

* * * * *

(f) * * *

(1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. See Example 33 of paragraph (b)(5) of this section.

* * * * *

(5) * * *

(iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or

* * * * *

(h) Determinations of fair market value--(1) In general. * * *

(2) Adjustments for noncompensatory options. The value of partnership property as reflected on the books of the partnership must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721-2(f)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(f) or (s) of this section. If the fair market value of outstanding noncompensatory options (as defined in §1.721-

2(f)) as of the date of the adjustment exceeds the consideration paid to the partnership to acquire the options, then the value of partnership property as reflected on the books of the partnership must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the consideration paid to the partnership to acquire the outstanding noncompensatory options (as defined in §1.721-2(f)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property as reflected on the books of the partnership must be increased by that excess to the extent of the unrealized loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized loss in proportion to their respective amounts of unrealized loss. However, any reduction or increase shall take into account the economic arrangement of the partners with respect to the property.

* * * * *

(s) Adjustments on the exercise of a noncompensatory option. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721-2(f)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid to the partnership to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be

determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the following requirements are met:

(1) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(f) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(f)(1) through (f)(4) of this section immediately after the exercise of the option.

(2) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(s)(1) of this section, the partnership first allocates any unrealized income, gain, or loss in partnership property (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income, gain, or loss (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, or loss in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. For purposes of the preceding sentence, if the exercising partner's initial capital account as determined under §1.704-1(b)(2)(iv)(b) and (d)(4) of this section would be less than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized

appreciation. If the exercising partner's initial capital account, as determined under §1.704-1(b)(2)(iv)(b) and (d)(4) of this section, would be greater than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

(3) If, after making the allocations described in paragraph (b)(2)(iv)(s)(2) of this section, the exercising partner's capital account does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account reflects the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or decrease in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(s)(3) must be allocated among the existing partners in accordance with the principles of this section. See Example 32 of paragraph (b)(5) of this section.

(4) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(s)(3) of this section (see paragraph (b)(4)(x) of this section). See Example 32 of paragraph (b)(5) of this section.

* * * * *

(4) * * *

(ix) Allocations with respect to noncompensatory options--(a) In general. A partnership agreement may grant to a partner that exercises a noncompensatory option (as defined in §1.721-2(f)) a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid to the partnership to acquire and exercise the option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. However, allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if--

(1) The holder of the noncompensatory option is not treated as a partner under §1.761-3;

(2) The partnership agreement requires that, while a noncompensatory option is outstanding, the partnership comply with the rules of paragraph (b)(2)(iv)(f) of this section and that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(s) of this section; and

(3) All material allocations and capital account adjustments under the partnership agreement would be respected under section 704(b) if there were no outstanding noncompensatory options issued by the partnership. See Examples 31 through 35 of paragraph (b)(5) of this section.

(b) Substantial economic effect under sections 168(h) and 514(c)(9)(E)(i)(II). An allocation of partnership income, gain, loss, or deduction to the partners will be deemed to have substantial economic effect for purposes of sections 168(h) and 514(c)(9)(E)(i)(II) if--

(1) The allocation would meet the substantial economic effect requirements of paragraph (b)(2) of this section if there were no outstanding noncompensatory options issued by the partnership; and

(2) The partnership satisfies the requirements of paragraph (b)(4)(ix)(a)(1), (2), and (3) of this section.

(x) Corrective allocations--(a)--In general. If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(s)(3) of this section (a capital account reallocation), then the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the required allocations are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the

partnership's allocation of the corresponding book item. See Example 32 of paragraph (b)(5) of this section.

(b) Timing. Section 706 and the regulations and principles thereunder apply in determining the items of income, gain, loss, and deduction that may be subject to corrective allocation.

(c) Allocation of gross income and gain and gross loss and deduction. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross income and gain as to further take into account the capital account reallocation.

(5) * * *

Example 31. (i) In Year 1, A and B each contribute cash of \$9,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for \$18,000. Later in Year 1, at a time when Property A is valued at \$20,000, LLC issues an option to C. The option allows C to buy 100 units in LLC for an exercise price of \$15,000 in Year 2. C pays \$1,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section. Also assume that C's option is a noncompensatory option under §1.721-2(f), and that C is not treated as a partner with respect to the option. Under paragraph (b)(2)(iv)(f)(5)(iv) of this section, LLC revalues its property in connection with the issuance of the option. The \$2,000 unrealized gain in Property A is allocated equally to A and B under the LLC agreement. In Year 2, C exercises the option, contributing the \$15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is \$35,000.

Year 1 After Issuance of the Option

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Cash			Cash		
Premium	\$1,000	\$1,000	Premium	\$1,000	\$1,000
Property A	<u>\$18,000</u>	<u>\$20,000</u>	A	\$9,000	\$10,000
			B	<u>\$9,000</u>	<u>\$10,000</u>
Total	\$19,000	\$21,000		\$19,000	\$21,000

Year 2 After Exercise of the Option

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Property A	\$18,000	\$35,000	A	\$9,000	\$17,000
Cash			B	\$9,000	\$17,000
Premium	\$ 1,000	\$ 1,000	C	<u>\$16,000</u>	<u>\$17,000</u>
Exercise Price	<u>\$15,000</u>	<u>\$15,000</u>			
Total	\$34,000	\$51,000		\$34,000	\$51,000

(ii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(f) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(s)(1) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(f) of this section immediately after the exercise of the option. Under paragraphs (b)(2)(iv)(b) and (b)(2)(iv)(d)(4) of this section, C's capital account is credited with the amount paid for the option (\$1,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are cash of \$16,000 (\$1,000 premium and \$15,000 exercise price contributed by C) and Property A, which has a value of \$35,000. Thus, the total value of LLC's property is \$51,000. C is entitled to LLC capital equal to 1/3 of this value, or \$17,000. As C is entitled to \$1,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) Under paragraph (b)(2)(iv)(s)(2) of this section, LLC must increase C's capital account from \$16,000 to \$17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section. The unrealized gain in LLC's property (Property A) which has not been reflected in the capital accounts previously is \$15,000 (\$35,000 value less \$20,000 book value). Under paragraph (b)(2)(iv)(s)(2) of this section, the first \$1,000 of this gain must be allocated to C, and the remaining \$14,000 of this gain is allocated equally to A and B in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(s)(2) of this section increases C's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. The \$17,000 of unrealized booked gain in Property A (\$35,000 value less \$18,000 basis) is shared \$8,000 to each A and B, and \$1,000 to C. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	<u>A</u>		<u>B</u>		<u>C</u>	
	<u>Tax</u>	<u>Book</u>	<u>Tax</u>	<u>Book</u>	<u>Tax</u>	<u>Book</u>
Capital account after exercise....	\$9,000	\$10,000	\$9,000	\$10,000	\$16,000	\$16,000
Revaluation amount	<u>0</u>	<u>\$7,000</u>	<u>0</u>	<u>\$7,000</u>	<u>0</u>	<u>\$1,000</u>
Capital account after revaluation.	\$9,000	\$17,000	\$9,000	\$17,000	\$16,000	\$17,000

Example 32. (i) Assume the same facts as in Example 31, except that, in Year 2, before the exercise of the option, LLC sells Property A for \$40,000, recognizing gain of \$22,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 2. With the proceeds (\$40,000), LLC purchases Property B, a nondepreciable property. Also assume that C exercises the noncompensatory option at the beginning of Year 3 and that, at the time C exercises the option, the value of Property B is \$41,000. In Year 3, LLC has gross income of \$3,000 and deductions of \$1,500.

Year 2 After Purchase of Property B

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Cash			Cash		
Premium	\$1,000	\$1,000	Premium	\$1,000	\$1,000
Property B	<u>\$40,000</u>	<u>\$40,000</u>	A	\$20,000	\$20,000
			B	<u>\$20,000</u>	<u>\$20,000</u>
Total	\$41,000	\$41,000		\$41,000	\$41,000

Year 3 After Exercise of the Option

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Property B	\$40,000	\$41,000	A	\$20,000	\$19,000
Cash	<u>\$16,000</u>	<u>\$16,000</u>	B	\$20,000	\$19,000
			C	<u>\$16,000</u>	<u>\$19,000</u>
Total	\$56,000	\$57,000		\$56,000	\$57,000

(ii) Under paragraphs (b)(2)(iv)(b) and (b)(2)(iv)(d)(4) of this section, C's capital account is credited with the amount paid for the option (\$1,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, C is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's properties are \$16,000 cash (\$1,000 option premium and \$15,000 exercise price contributed by C) and Property B, which has a value of \$41,000. Thus, the total value of LLC's property is \$57,000. C is entitled to LLC capital equal to 1/3 of this amount, or \$19,000. As C is entitled to \$3,000 more LLC capital than C's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) In lieu of revaluing LLC's property under paragraph (b)(2)(iv)(f) of this section immediately before the option is exercised, under paragraph (b)(2)(iv)(s)(1) of this section LLC must revalue its property under the principles of paragraph (b)(2)(iv)(f) of this section immediately after the exercise of the option. Under paragraph (b)(2)(iv)(s) of this section, LLC must increase C's capital account from \$16,000 to \$19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating all \$1,000 of unrealized gain from the revaluation to C under paragraph (b)(2)(iv)(s)(2). This brings C's capital account to \$17,000.

(iv) Next, under paragraph (b)(2)(iv)(s)(3) of this section, LLC must reallocate \$2,000 of capital from the existing partners (A and B) to C to bring C's capital account to \$19,000 (the capital account reallocation). As A and B shared equally in all items from Property A, whose sale gave rise to the need for the capital account reallocation, each member's capital account is reduced by 1/2 of the \$2,000 reduction (\$1,000).

(v) Under paragraph (b)(2)(iv)(s)(4) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 3, LLC has gross income of \$3,000 and deductions of \$1,500. Under paragraph (b)(2)(x)(c), LLC must allocate the book gross income of \$3,000 equally among A, B, and C, but for tax purposes, however, LLC must allocate all of its gross income (\$3,000) to C. LLC's book and tax deductions (\$1,500) will then be allocated equally among A, B, and C. The \$1,000 unrealized booked gain in Property B has been allocated entirely to C. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	<u>A</u>		<u>B</u>		<u>C</u>	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise.....	\$20,000	\$20,000	\$20,000	\$20,000	\$16,000	\$16,000
Revaluation	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>\$1,000</u>
Capital account after revaluation..	\$20,000	\$20,000	\$20,000	\$20,000	\$16,000	\$17,000
Capital account reallocation.....	<u>0</u>	<u>(\$1,000)</u>	<u>0</u>	<u>(\$1,000)</u>	<u>0</u>	<u>\$2,000</u>
Capital account after capital account reallocation.....	\$20,000	\$19,000	\$20,000	\$19,000	\$16,000	\$19,000
Income allocation (Yr.3)	0	\$1,000	0	\$1,000	\$3,000	\$1,000
Deduction allocation (Yr. 3)	<u>(\$500)</u>	<u>(\$500)</u>	<u>(\$500)</u>	<u>(\$500)</u>	<u>(\$500)</u>	<u>(\$500)</u>
Capital account at end of year 3.....	\$19,500	\$19,500	\$19,500	\$19,500	\$18,500	\$19,500

Example 33. (i) In Year 1, D and E each contribute cash of \$10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two nondepreciable properties, Property A and Property B, for \$10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at \$10,000 each, LLC issues an option to F. The option allows F to buy 100 units in LLC for an exercise price of \$15,000 in Year 2. F pays \$2,000 to LLC to purchase the option. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section. Also assume that F's option is a noncompensatory option under §1.721-2(f), and that F is not treated as a partner with respect to the option.

End of Year 1

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Cash			Cash		
Premium	\$2,000	\$2,000	Premium	\$2,000	\$2,000
Property A	\$10,000	\$10,000	D	\$10,000	\$10,000
Property B	<u>\$10,000</u>	<u>\$10,000</u>	E	<u>\$10,000</u>	<u>\$10,000</u>
Total	\$22,000	\$22,000		\$22,000	\$22,000

(ii) In year 2, prior to the exercise of F's option, G contributes \$18,000 to LLC for 100 units in LLC. At the time of G's contribution, Property A has a value of \$32,000 and a basis of \$10,000, Property B has a value of \$5,000 and a basis of \$10,000, and the fair market value of F's option is \$3,000. In year 2, LLC has no item of income, gain, loss, deduction, or credit.

(iii) Upon G's admission to the partnership, the capital accounts of D and E (which were \$10,000 each prior to G's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's property. Property A has \$22,000 of unrealized gain and Property B has \$5,000 of unrealized loss. Under paragraph (b)(2)(iv)(f)(1) of this section, the adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. The fair market value of partnership property must be reduced by the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by F to acquire the option ($\$3,000 - \$2,000 = \$1,000$) (under paragraph (b)(2)(iv)(h)(2) of this section), but only to the extent of the unrealized appreciation in LLC property that has not been reflected in the capital accounts previously (\$22,000). This \$1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation not reflected in the capital accounts previously. Therefore, the book value of Property A is \$31,000. Accordingly, the revaluation adjustments must reflect only \$16,000 of the net appreciation in LLC's property (\$21,000 of unrealized gain in Property A and \$5,000 of unrealized loss in Property B). Thus, D's and E's capital accounts (which were \$10,000 each prior to G's admission) must be adjusted upward (by \$8,000) to \$18,000 each. The \$21,000 of built-in gain in Property A and the \$5,000 of built-in loss in Property B must be allocated equally between D and E in accordance with section 704(c) principles.

	<u>Assets</u>			
	<u>Basis</u>	<u>Value</u>	<u>Option Adjustment</u>	<u>704(b) Book</u>
Property A	\$10,000	\$32,000	(\$1,000)	\$31,000
Property B	\$10,000	\$ 5,000	0	\$ 5,000
Cash	<u>\$ 2,000</u>	<u>\$ 2,000</u>	<u>0</u>	<u>\$ 2,000</u>
Subtotal	\$22,000	\$39,000	(\$1,000)	\$38,000
Cash Contributed by G	<u>\$18,000</u>	<u>\$18,000</u>	<u>0</u>	<u>\$18,000</u>
Total	\$40,000	\$57,000	(\$1,000)	\$56,000

	<u>Liabilities and Capital</u>		
	<u>Tax</u>	<u>Value</u>	<u>704(b) Book</u>
Cash			
Premium			
(option value)	\$ 2,000	\$3,000	\$2,000
D	\$10,000	\$18,000	\$18,000
E	\$10,000	\$18,000	\$18,000
G	<u>\$18,000</u>	<u>\$18,000</u>	<u>\$18,000</u>
Total	\$40,000	\$57,000	\$56,000

(iv) In year 2, after the admission of G, when Property A still has a value of \$32,000 and a basis of \$10,000 and Property B still has a value of \$5,000 and a basis of \$10,000, F exercises the option. On the exercise of the option, F's capital account is credited with the amount paid for the option (\$2,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, F is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC's capital). Immediately after the exercise of the option, LLC's properties are worth \$72,000 (\$15,000 contributed by F, plus the value of LLC property prior to the exercise of the option, \$57,000). F is entitled to LLC capital equal to 1/4 of this value, or \$18,000. As F is entitled to \$1,000 more LLC capital than F's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(v) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase F's capital account from \$17,000 to \$18,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section and allocating the first \$1,000 of unrealized gain to F. The total unrealized gain which has not been reflected in the capital accounts previously is \$1,000 (the difference between the actual value of Property A, \$32,000, and the book value of Property A, \$31,000). The entire \$1,000 of book gain is allocated to F under paragraph (b)(2)(iv)(s)(2) of this section. Because the revaluation of LLC property under paragraph (b)(2)(iv)(s)(2) of this section increases F's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. The (\$5,000) of unrealized booked loss in Property B has been allocated (\$2,500) to each D and E, and the \$22,000 of unrealized booked gain in Property A has been allocated \$10,500 to each D and E, and \$1,000 to F. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	<u>D</u>		<u>E</u>		<u>G</u>		<u>F</u>	
	Tax	Book	Tax	Book	Tax	Book	Tax	Book
Capital account after admission of G.....	\$10,000	\$18,000	\$10,000	\$18,000	\$18,000	\$18,000	0	0
Capital account after exercise of F's option	\$10,000	\$18,000	\$10,000	\$18,000	\$18,000	\$18,000	\$17,000	\$17,000
Revaluation.....	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>\$1,000</u>
Capital account after revaluation.....	\$10,000	\$18,000	\$10,000	\$18,000	\$18,000	\$18,000	\$17,000	\$18,000

Example 34. (i) On the first day of Year 1, H, I, and J form LLC, a limited liability company classified as a partnership for Federal tax purposes. H and I each contribute \$10,000 cash to LLC for 100 units of common interest in LLC. J contributes \$10,000 cash for a convertible preferred interest in LLC. J's convertible preferred interest entitles J to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of J's unreturned capital. J's convertible preferred interest also entitles J to convert, in Year 3, J's preferred interest into 100 units of common interest. If J converts, J has the right to the same share of LLC capital as J would have had if J had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remain after payment of the preferred return. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section. Also assume that J's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under §1.721-2(f), and that, prior to the exercise of the conversion right, the conversion right is not treated as a partnership interest.

(ii) LLC uses the \$30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of \$2,500, comprised of \$4,500 of gross income and \$2,000 of depreciation. It allocates \$1,000 of net income to J and distributes \$1,000 to J in each year. LLC allocates the remaining \$1,500 of net income equally to H and I in each year but makes no distributions to H and I.

	<u>H</u>		<u>I</u>		<u>J</u>	
	Tax	Book	Tax	Book	Tax	Book
Capital account upon formation.....	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000
Allocation of income Years 1 and 2.....	\$1,500	\$1,500	\$1,500	\$1,500	\$2,000	\$2,000
Distributions Years 1 and 2.....	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>(\$2,000)</u>	<u>(\$2,000)</u>
Capital account at end of Year 2.....	\$11,500	\$11,500	\$11,500	\$11,500	\$10,000	\$10,000

(iii) At the beginning of Year 3, when Property Z has a value of \$38,000 and a basis of \$26,000 (\$30,000 original basis less \$4,000 of depreciation) and LLC has accumulated undistributed cash of \$7,000 (\$9,000 gross receipts less \$2,000 distributions), J converts J's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(b) and (b)(2)(iv)(d)(4) of this section, J's capital account after the conversion equals J's capital account before the conversion, \$10,000. On the conversion of the preferred interest, however, J is entitled to LLC capital corresponding to 100 units of common interest in LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC property is \$45,000. J is entitled to LLC capital equal to 1/3 of this value, or \$15,000. As J is entitled to \$5,000 more LLC capital than J's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

	Assets <u>Basis</u>	<u>Value</u>		Liabilities and Capital <u>Basis</u>	<u>Value</u>
Property Z	\$26,000	\$38,000	H	\$11,500	\$15,000
Undistributed			I	\$11,500	\$15,000
Income	<u>\$7,000</u>	<u>\$7,000</u>	J	<u>\$10,000</u>	<u>\$15,000</u>
Total	\$33,000	\$45,000	Total	\$33,000	\$45,000

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase J's capital account from \$10,000 to \$15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first \$5,000 of unrealized gain from that revaluation to J. The unrealized gain in Property Z is \$12,000 (\$38,000 value less \$26,000 basis). The first \$5,000 of this unrealized gain must be allocated to J under paragraph (b)(2)(iv)(s)(2) of this section. The remaining \$7,000 of the unrealized gain must be allocated equally to H and I in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(s)(2) of this section increases J's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. The \$12,000 of unrealized booked gain in Property Z has been allocated \$3,500 to each H and I, and \$5,000 to J. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	<u>H</u>		<u>I</u>		<u>J</u>	
	Tax	Book	Tax	Book	Tax	Book
Capital account prior to conversion...	\$11,500	\$11,500	\$11,500	\$11,500	\$10,000	\$10,000
Revaluation on conversion.....	<u>0</u>	<u>\$3,500</u>	<u>0</u>	<u>\$3,500</u>	<u>0</u>	<u>\$5,000</u>
Capital account after conversion.....	\$11,500	\$15,000	\$11,500	\$15,000	\$10,000	\$15,000

Example 35. (i) On the first day of Year 1, K and L each contribute cash of \$10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows \$10,000 from M. Under the terms of the debt instrument, interest of \$1,000 is unconditionally payable at the end of each year and the \$10,000 stated principal is repayable in five years. Throughout the term of the indebtedness, M has the right to convert the debt instrument into 100 units in LLC. If M converts, M has the right to the same share of LLC capital as M would have had if M had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement satisfies the requirements of paragraph (b)(2) of this section and requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section. Also assume that M's right to convert the debt into an interest in LLC qualifies as a noncompensatory option under §1.721-2(f), and that, prior to the exercise of the conversion right, M is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the \$30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of \$2,000, comprised of \$5,000 of gross income, \$2,000 of depreciation, and interest expense (representing payments of interest on the loan from M) of \$1,000. LLC allocates this income equally to K and L but makes no distributions to either K or L.

	K		L		M	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	\$10,000	\$10,000	\$10,000	\$10,000	0	0
Year 1 net income	\$1,000	\$1,000	\$1,000	\$1,000	0	0
Years 2 net income	\$1,000	\$1,000	\$1,000	\$1,000	0	0
Years 3 net income	<u>\$1,000</u>	<u>\$1,000</u>	<u>\$1,000</u>	<u>\$1,000</u>	<u>0</u>	<u>0</u>
Year 4 initial capital account.....	\$13,000	\$13,000	\$13,000	\$13,000	0	0

(iii) At the beginning of year 4, at a time when Property D, LLC's only asset, has a value of \$33,000 and basis of \$24,000 (\$30,000 original basis less \$6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of \$12,000 (\$15,000 gross income less \$3,000 of interest payments) in LLC, M converts the debt into a 1/3 interest in LLC. Under paragraphs (b)(2)(iv)(b) and (b)(2)(iv)(d)(4) of this section, M's capital account after the conversion is the adjusted issue price of the debt immediately before M's conversion of the debt, \$10,000, plus any accrued but unpaid qualified stated interest on the debt, \$0. On the conversion of the debt, however, M is entitled to receive LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC's property is \$45,000. M is entitled to LLC capital equal to 1/3 of this value, or \$15,000. As M is entitled to \$5,000 more LLC capital than M's capital contribution to LLC (\$10,000), the provisions of paragraph (b)(2)(iv)(s) of this section apply.

Assets			Liabilities and Capital		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Property D	\$24,000	\$33,000	K	\$13,000	\$15,000
Cash	<u>\$12,000</u>	<u>\$12,000</u>	L	\$13,000	\$15,000
			M	<u>\$10,000</u>	<u>\$15,000</u>
Total	\$36,000	\$45,000		<u>\$36,000</u>	<u>\$45,000</u>

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase M's capital account from \$10,000 to \$15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first \$5,000 of unrealized gain from that revaluation to M. The unrealized gain in Property D is \$9,000 (\$33,000 value less \$24,000 basis). The first \$5,000 of this unrealized gain must be allocated to M under paragraph (b)(2)(iv)(s)(2) of this section, and the remaining \$4,000 of the unrealized gain must be allocated equally to K and L in accordance with the LLC agreement. Because the revaluation of LLC property under paragraph (b)(2)(iv)(s)(2) of this section increases M's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. The \$9,000 unrealized booked gain in property D has been allocated \$2,000 to each K and L, and \$5,000 to M. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	<u>K</u>		<u>L</u>		<u>M</u>	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise.....	\$13,000	\$13,000	\$13,000	\$13,000	0	0
Capital account after exercise.....	\$13,000	\$13,000	\$13,000	\$13,000	\$10,000	\$10,000
Revaluation.....	<u>0</u>	<u>\$ 2,000</u>	<u>0</u>	<u>\$ 2,000</u>	<u>0</u>	<u>\$ 5,000</u>
Capital account after revaluation.....	\$13,000	\$15,000	\$13,000	\$15,000	\$10,000	\$15,000

Par. 4. Section 1.704-3 is amended by revising the first sentence of paragraph (a)(6)(i) to read as follows:

§1.704-3 Contributed property.

(a) * * *

(6) * * *(i) * * * The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations). * * *

* * * * *

Par. 5. Section 1.721-2 is added to read as follows:

§1.721-2 Noncompensatory options.

(a) Exercise of a noncompensatory option--(1) In general. Notwithstanding §1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (g)(4) of this section) of a noncompensatory option (as defined in paragraph (f) of this section). Except as provided in paragraph (a)(2) of this section, section 721 applies to the exercise of a noncompensatory option when the holder pays the exercise price with either property or cash, regardless of whether the terms of the option require or permit cash payment. However, if the exercise price (as defined in paragraph (g)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, then general tax principles will apply to

determine the tax consequences of the transaction.

(2) Exception. Section 721 does not apply to the exercise of a noncompensatory option to the extent that the exercise price is satisfied with the partnership's obligation to the option holder for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder's holding period for the obligation. The issuing partnership will not recognize gain or loss upon the transfer of a partnership interest to an exercising option holder in satisfaction of such unpaid rent, royalties, or interest (including accrued original issue discount).

(b) Transfer of property or satisfaction of an obligation in exchange for a noncompensatory option--(1) In general. Except as provided in paragraph (b)(2) of this section, section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option, or to the satisfaction of a partnership obligation with a noncompensatory option.

(2) Exception. Section 721 does apply to a transfer of property to a partnership in exchange for convertible equity (as defined in paragraph (g)(3) of this section).

(c) Lapse of a noncompensatory option. Section 721 does not apply to the lapse of a noncompensatory option.

(d) Cash settlement of a noncompensatory option. Section 721 does not apply to the settlement of a noncompensatory option in cash or property other than a partnership interest in the issuing partnership.

(e) Issuance of a partnership interest in satisfaction of indebtedness for interest on convertible debt. Section 721 does not apply to the transfer of a partnership interest to a noncompensatory option holder upon conversion of convertible debt in the

partnership to the extent that the transfer is in satisfaction of the partnership's indebtedness for unpaid interest (including accrued original issue discount) on the convertible debt that accrued on or after the beginning of the convertible debt holder's holding period for the indebtedness. The debtor partnership will not, however, recognize gain or loss upon such conversion. For rules in determining whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount, see §§1.446-2 and 1.1275-2, respectively.

(f) Scope. The provisions of this section apply only to noncompensatory options. For purposes of this section, the term noncompensatory option means an option (as defined in paragraph (g)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(g) Definitions. The following definitions apply for the purposes of this section:

(1) Option means a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement, the conversion feature of convertible debt (as defined in paragraph (g)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (g)(3) of this section). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a futures contract, a forward contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(2) Convertible debt is any indebtedness of a partnership that is convertible into

an interest in the partnership that issued the debt.

(3) Convertible equity is equity in a partnership that is convertible into a different equity interest in the partnership that issued the convertible equity.

(4) Exercise means the exercise of an option in exchange for an interest in the issuing partnership or the conversion of convertible debt or convertible equity into an interest in the issuing partnership.

(5) Exercise price means, in the case of a call option, the exercise price of the call option; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of §1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest on the debt and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

(h) Example. The following example illustrates the provisions of this section:

Example. In Year 1, L and M form general partnership LM with cash contributions of \$5,000 each, which are used to purchase land, Property D, for \$10,000. In that same year, LM issues an option to N to buy a one-third interest in LM at any time before the end of Year 3. The exercise price of the option is \$5,000, payable in either cash or property. N transfers Property E with a basis of \$600 and a value of \$1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (f) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with §1.1001-1, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes \$400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any income for the premium (the property received in exchange for the option). The partnership has a basis of \$1,000 in Property E. In Year 3, when the partnership property is valued at \$16,000, N exercises the option, contributing Property F with a basis of \$3,000 and a fair market value of \$5,000 to the

partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of \$3,000 in Property F. The partnership does not recognize income for the premium (Property E) upon exercise of the option. See §1.704-1(b)(2)(iv)(d)(4) and (s) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(i) Effective/applicability date. This section applies to noncompensatory options that are issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Par. 6. Section 1.761-3 is added to read as follows:

§1.761-3 Certain option holders treated as partners.

(a) Noncompensatory option treated as a partnership interest--(1) General rule.

A noncompensatory option (as defined in paragraph (b)(2) of this section) is treated as a partnership interest for all Federal tax purposes if, on the date of a measurement event (as defined in paragraph (c) of this section) with respect to the option--

(i) The noncompensatory option (and any agreements associated with it) provides the option holder with rights that are substantially similar to the rights afforded a partner (as determined under paragraph (d) of this section); and

(ii) There is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and noncompensatory option holder's aggregate Federal tax liabilities (as determined under paragraph (e) of this section).

(2) Continuing applicability of general principles of law. The fact that an option is not treated as a partnership interest under this section does not prevent the option from being treated as a partnership interest under general principles of Federal tax law.

(3) Timing of characterization. If a noncompensatory option is treated under this

section as a partnership interest, that treatment applies, as the case may be, upon the issuance of the option, or immediately before any other measurement event that gave rise to the characterization under paragraph (a)(1) of this section.

(4) Effect of characterization. If a noncompensatory option is treated as a partnership interest under this section or under general principles of law, the option holder will be treated as a partner with respect to the partnership interest and will receive a distributive share of the partnership's income, gain, loss, deduction, or credit (or items thereof), as determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704-1(b)(3). Once a noncompensatory option is treated as a partnership interest, in no event may it be characterized as an option thereafter.

(b) Definitions. For purposes of this section:

(1) Look-through entity. Look-through entity means an entity described in §1.704-1(b)(2)(iii)(d)(2).

(2) Noncompensatory option. Noncompensatory option means an option (as defined in paragraph (b)(3) of this section) issued by a partnership, other than an option issued in connection with the performance of services. For purposes of applying this section, an option that would be a noncompensatory option under this paragraph if it had been issued by a partnership is a noncompensatory option if the option was issued by an eligible entity (as defined in §301.7701-3(a)) that would become a partnership under §301.7701-3(f)(2) if the noncompensatory option holder were treated as a partner. Also for purposes of applying this section, if a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership.

(3) Option. An option is a contractual right to acquire an interest in the issuing partnership, including a call option, warrant, or other similar arrangement. In addition, an option includes convertible debt (as defined in §1.721-(g)(2)) and convertible equity (as defined in §1.721-(g)(3)). To achieve the purposes of this section, the Commissioner can treat other contractual agreements, including a forward contract, a futures contract, or a notional principal contract, as an option. A contract that otherwise constitutes an option will not fail to be treated as an option for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(4) Underlying partnership interest. Underlying partnership interest means the interest in the issuing partnership that would be acquired by the noncompensatory option holder upon exercise of the noncompensatory option.

(c) Measurement event--(1) General rule. Except as provided in paragraph (c)(2) of this section, a measurement event with respect to a noncompensatory option is any of the following events:

- (i) Issuance of the noncompensatory option;
- (ii) An adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (as defined in paragraph (b)(4) of this section) (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest);
- (iii) Transfer of the noncompensatory option if either:
 - (A) The option may be exercised (or settled) more than 12 months after its issuance, or

(B) The transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder (under paragraph (a)(1)(ii) of this section);

(2) Events not treated as measurement events. A measurement event does not include the following events:

(i) A transfer of the noncompensatory option at death, between spouses or former spouses under section 1041, or in a transaction that is disregarded for Federal tax purposes;

(ii) A modification that neither materially increases the likelihood that the noncompensatory option will be exercised (as described in paragraph (d)(2) of this section) nor provides the noncompensatory option holder with partner attributes (as described in paragraph (d)(3) of this section);

(iii) A change in the strike price of a noncompensatory option or in the interests in the issuing partnership that may be issued or transferred pursuant to the noncompensatory option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the noncompensatory option holder;

(iv) Any other event as provided in guidance published in the Internal Revenue Bulletin.

(d) Rights substantially similar to partner rights--(1) In general. A noncompensatory option provides the holder with rights that are substantially similar to

the rights afforded to a partner if either the option is reasonably certain to be exercised or the option holder possesses partner attributes.

(2) Reasonable certainty of exercise--(i) General rule. The determination of whether a noncompensatory option is reasonably certain to be exercised at the time of a measurement event is based on all the facts and circumstances, including--

(A) The fair market value of the partnership interest that is the subject of the noncompensatory option;

(B) The strike price of the noncompensatory option;

(C) The term of the noncompensatory option;

(D) The volatility of the value or income of the issuing partnership or the underlying partnership interest;

(E) Anticipated distributions by the partnership during the term of the noncompensatory option;

(F) Any other special option features, such as a strike price that fluctuates;

(G) The existence of related options, including reciprocal options; and

(H) Any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised.

(ii) Safe harbors--(A) General rule. Except as provided in paragraph (d)(2)(ii)(C) of this section, a noncompensatory option is not considered reasonably certain to be exercised if, as of the date of a measurement event with respect to the noncompensatory option--

(1) The option may be exercised no more than 24 months after the date of the measurement event and the strike price is equal to or greater than 110 percent of the

fair market value of the underlying partnership interest on the date of the measurement event; or

(2) The terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying partnership interest on the exercise date.

(B) Options exercisable at fair market value. For purposes of paragraph (d)(2)(ii)(A) of this section, an option whose strike price is determined by a formula is considered to have a strike price equal to or greater than the fair market value of the underlying partnership interest on the exercise date if the formula is agreed upon by the parties when the option is issued in a bona fide attempt to arrive at the fair market value on the exercise date and is to be applied based on the facts and circumstances in existence on the exercise date.

(C) Exception. The safe harbors of paragraph (d)(2)(ii)(A) of this section do not apply if the parties to the noncompensatory option had a principal purpose described in paragraph (c)(1)(iii)(B) of this section with respect to a measurement event for that option (or, if multiple options were issued pursuant to a plan, a measurement event with respect to any option issued pursuant to that plan).

(D) Failure to satisfy safe harbor. Failure of an option to satisfy one of the safe harbors of paragraph (d)(2)(ii)(A) does not affect the determination of whether an option is treated as reasonably certain to be exercised.

(3) Partner attributes--(i) General rule. The determination of whether a holder of a noncompensatory option possesses partner attributes is based on all the facts and circumstances, including whether the option holder, directly or indirectly, through the

option agreement or a related agreement, is provided with voting rights or managerial rights in the partnership.

(ii) Certain factors that conclusively establish partner attributes. For purposes of this section, a noncompensatory option holder has partner attributes if, based on all the facts and circumstances--

(A) The option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interests; or

(B) The option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses.

(iii) Special rules. The following rules apply for purposes of paragraphs (d)(3)(i) and (d)(3)(ii) of this section:

(A) Rights in the issuing partnership possessed by a noncompensatory option holder solely by virtue of owning an interest in the issuing partnership are not taken into account, provided that those rights are no greater than the rights granted to other partners owning substantially similar interests in the partnership and who do not hold noncompensatory options in the partnership.

(B) If all of the partners owning substantially similar interests in the issuing partnership also hold noncompensatory options in the partnership, or if none of the other partners owns substantially similar interests in the partnership, then all facts and circumstances will be considered in determining whether the rights in the partnership

possessed by the option holder are possessed solely by virtue of owning a partnership interest. If those rights are possessed solely by virtue of owning a partnership interest, they are not taken into account.

(C) A noncompensatory option holder will not ordinarily be considered to possess partner attributes solely because the noncompensatory option agreement significantly controls or restricts, or the noncompensatory option holder has the ability to significantly control or restrict, a partnership decision that could substantially affect the value of the underlying partnership interest. In particular, the following abilities of the option holder will not be treated as partner attributes:

(1) The ability to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or options while the noncompensatory option is outstanding.

(2) The ability to choose the partnership's section 704(c) method for partnership properties.

(D) When the applicable measurement event is a transfer described in paragraph (c)(1) of this section, the partner attributes of the transferee, not the transferor, are taken into account.

(E) The option holder will be treated as owning all partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the option holder. For purposes of the preceding sentence, a person related to the option holder is defined as any person bearing a relationship to the option holder described in section 267(b) or 707(b).

(e) Substantial tax reduction requirement--(1) General rule. The determination of

whether there is a strong likelihood that the failure to treat a noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the noncompensatory option holder's aggregate Federal tax liabilities is based on all the facts and circumstances, including--

(i) The interaction of the allocations of the issuing partnership and the partners' and noncompensatory option holder's Federal tax attributes (taking into account tax consequences that result from the interaction of the allocations with the partners' and noncompensatory option holder's Federal tax attributes that are unrelated to the partnership);

(ii) The absolute amount of the Federal tax reduction;

(iii) The amount of the reduction relative to overall Federal tax liability; and

(iv) The timing of items of income and deductions.

(2) Special rules. For purposes of applying paragraph (e)(1) of this section to a partner or noncompensatory option holder that is--

(i) A look-through entity (as defined in paragraph (b)(1) of this section), the Federal tax consequences that result from the interaction of allocations of the partnership and the Federal tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner or noncompensatory option holder, whether directly, or indirectly through one or more look-through entities, must be taken into account; or

(ii) A member of a consolidated group (within the meaning of §1.1502-1(h)), the tax consequences that result from the interaction of the issuing partnership's allocations and the tax attributes of the consolidated group and the tax attributes of another

member with respect to a separate return year must be taken into account.

(f) Examples. The following examples illustrate the provisions of this section.

For purposes of all examples, assume that PRS is a partnership for Federal tax purposes, none of the noncompensatory option holders or partners are related persons, and that general principles of law do not apply to treat the noncompensatory option as a partnership interest. The examples read as follows:

Example 1. Active trade or business. PRS is engaged in an active real estate business, the amount of income, gain, loss, and deductions from which cannot be predicted with any reasonable certainty. In exchange for a premium of \$100x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for \$110x at any time during a 3-year period commencing on the date on which the option is issued. At the time of the issuance of the noncompensatory option, a 10 percent interest in PRS has a fair market value of \$100x. Due to the nature of PRS's business, the value of a 10 percent PRS interest in 3 years is not reasonably predictable as of the time the noncompensatory option is issued. Assuming there are no other facts affecting the certainty of the option's exercise, it is not reasonably certain that A's option will be exercised. Therefore, assuming that A does not possess partner attributes as described in paragraph (d)(3) of this section, A's noncompensatory option is not treated as a partnership interest under paragraph (a)(1) of this section.

(g) Effective/applicability date. This section applies to noncompensatory options issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Par. 7. Section 1.1272-1 is amended by adding a sentence at the end of paragraph (e) to read as follows:

§1.1272-1 Current inclusion of OID in income.

* * * * *

(e) * * * For debt instruments issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal

tax purposes, as either a partnership or a corporation.

* * * *

Par. 8. Section 1.1273-2 is amended by adding a sentence at the end of paragraph (j) to read as follows:

§1.1273-2 Determination of issue price and issue date.

* * * * *

(j) * * * For debt instruments issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 9. Section 1.1275-4 is amended by adding a sentence at the end of paragraph (a)(4) to read as follows:

§1.1275-4 Contingent payment debt instruments.

(a) * * *

(4) * * * For debt instruments issued on or after **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**, the term stock in the

preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

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Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: January 24, 2013.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

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